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RUEHBS/USEU BRUSSELS 0034

UNCLAS SECTION 01 OF 03 LILONGWE 000574

SENSITIVE
SIPDIS

LONDON FOR AFRICA WATCHER PETER LORD

E.O. 12958: N/A
TAGS: EFIN EAID PREL MI
SUBJECT: MALAWI: DONORS TO SUPPORT GOM THROUGH FISCAL, BOP
CRUNCH IN LEAD UP TO ELECTIONS

REF: A. CO LILONGWE 365
¶B. UN LILONGWE 513

LILONGWE 00000574 001.2 OF 003

¶1. (SBU) SUMMARY: A recent IMF visit to Malawi highlighted a $40 million dollar budget shortfall the GOM will face as a result of the rising cost of its much-vaunted fertilizer subsidy program. Commercial borrowing to cover this gap would only exacerbate another looming problem: a foreign exchange shortage that is expected to take Malawi's reserves below one month's import coverage by early 2009. Leading donors, including the IMF and World Bank, agreed informally on Sept. 24 that they should all do what they can to mitigate fiscal and forex pressures on the GOM as the country approaches crucial and highly competitive elections in May ¶2009. In return, the World Bank and IMF would seek only modest GOM commitments to 1) review recent policy decisions to restrict commercial trade in maize; and 2) scale back discretionary spending. COMMENT: The goal of this approach would be to preserve the significant macroeconomic progress over the last several years through the dangerous electoral period. The risk of the developing support package is that it might promote "moral hazard," encouraging irresponsible GOM behavior in the future such as selling off current government maize stocks at highly subsidized prices just prior to the election. All things considered, post favors USG support for IMF and World Bank efforts. END SUMMARY.

IMF MISSION FLAGS IMPENDING FISCAL AND FOREX CRUNCH
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¶2. (SBU) The mid-September visit of the IMF's Washington-based Country Director for Malawi, Andrew Berg, highlighted for both the GOM and its international development partners the major macroeconomic challenges the country will face in the coming months. (Post previewed these challenges and their political context in ref A in June.) IMF Resident Representative Maitlan MacFarland outlined the conclusions of the Mission and expected next steps at a meeting of donor country Heads of Mission (HOMs) Sept. 24 in Lilongwe.

¶3. (SBU) The first major challenge is fiscal. As per reftel, the increased cost of fertilizer on the international market has raised the pricetag of the GOM's widely-praised fertilizer subsidy program by about USD 70 million. Dialogue with the GOM during the IMF visit yielded agreement to reduce this expected budgetary gap to around USD 40 million using higher but still realistic estimates on expected GOM revenue, and making similar revisions to expected flows of

already-promised foreign assistance. The GOM also agreed to scale back some discretionary spending on development programs of its own.

¶4. (SBU) The second major challenge is an expected crunch in foreign exchange reserves. The increased cost of the fertilizer subsidy program together with higher oil prices have more than compensated for higher forex receipts from Malawi's bumper tobacco crop. These negative developments mean that Malawi's reserves are already expected to drop below USD 200 million, the level of coverage for one month's imports, by early 2009, exacerbating what is always the most difficult quarter for forex reserves in Malawi. The IMF warned that any significant GOM borrowing to cover its fiscal gap during the same period might provoke a balance of payments crisis, but noted that senior GOM leaders were aware of this danger.

DONORS AGREE TO PROTECT MUTHARIKA'S PROGRESS

¶5. (SBU) The IMF ResRep prefaced his comments on Malawi's looming problems with a summary of the GOM's significant achievements over the last several years under President Mutharika. He noted that real GDP growth had exceeded eight percent in both 2007 and 2008, and that barring bad weather, Malawi would likely see 6.5 percent growth in 2009. MacFarland predicted that inflation, which had risen over the last several months to 9.1 percent, had likely peaked, and would decline into 2009. Interest rates had been rising, he pointed out, and excess liquity in the banking system lessening. EU Resident Representative Alessandro Mariani commented that Malawi's difficulties with rising commodity prices were not unique, and that terms of trade shocks had

left many other developing countries in far worse shape than Malawi.

¶6. (SBU) MacFarland, Mariani and other donor representatives at the HOMs' meeting agreed that the real challenge was to get through the eight months remaining until Malawi's national elections in May 2009. To accomplish this, Malawi would need increased external support and GOM spending restraint. MacFarland indicated that the IMF was prepared to help Malawi, although the just-concluded visit had not reached a formal agreement. He said that Fund officials in Washington expected to continue talks with the GOM at the Fund's annual meetings in mid-October. Talks so far had focused on a one-year agreement under the External Shocks Facility (ESF), rather than a renewal of Malawi's current Poverty Reduction and Growth Facility (PRGF). The ESF could provide the GOM with access to more funds than the PRFG -- potentially around USD 50 million -- and over a shorter period. The IMF envisioned pursuing a longer-term PRGF with whatever government emerged from Malawi's elections next year. MacFarland said that the largest obstacle to agreement on the ESF at the moment was the lack of agreement between the GOM and World Bank on several issues, most notably recent GOM policy decisions related to maize markets and Malawi's marketing board, ADMARC (ref B).

WORLD BANK PRESSES MAIZE CONCERNS, BUT NOT TOO HARD

¶7. (SBU) World Bank Deputy Representative David Rohrbach briefed HOMs that the World Bank had not yet reached full agreement with the GOM on policy conditions for disbursements under Malawi's Poverty Reduction Support Credit (PRSC). The main sticking point was the Bank's objection to recent price controls and restrictions on private traders in the market for maize, Malawi's staple food. Other donors, including the USG, have shared this concern (ref B). Rohrbach told HOMs that Finance Minister Goodall Gondwe had just written to the WB and other budget support donors to confirm that the GOM's recent restrictions on the maize trade were "temporary

measures" designed to deal with "market anomalies." Gondwe expected that the policies would be rescinded some time in early 2009. The World Bank welcomed those comments, Rohrbach said, although it was not fully confident that ADMARC's role as exclusive buyer and seller of maize would be modified within the time frame Gondwe indicated. Rohrbach indicated that at the end of the day, the Bank "was trying not to be dogmatic," and limit its ambitions to engaging the GOM in a meaningful dialogue on maize policy with a view toward addressing problems post-election. He anticipated that if a couple of other more minor issues could be resolved, then an agreement was possible by mid-October to disburse PRSC funds.

PASSING THE HAT

¶8. (SBU) The World Bank rep told HOMs that the WB was considering increased support for Malawi to close its fiscal gap. Nick Dyer, local representative of the UK's Department for International Development (DfID) indicated that his government was considering additional support worth nearly USD 20 million. EU Rep Mariani pledged approximately USD 13 million in additional funding. Representatives from the African Development Bank and Irish Government indicated that they might be able to make USD 5 million and USD 2 million available respectively to support the fertilizer subsidy program. ResRep MacFarland confirmed that the IMF would of course focus its efforts on balance of payments support. He summarized the discussion by saying that the GOM's current problems were "serious, but surmountable" given the current attitudes of international partners and the GOM's own commitment to avoid election-year profligacy.

DOWNSIDE RISKS

¶9. (SBU) While there was broad agreement among HOMs about the need to preserve Malawi's current macro stability and defer concerns about some key agricultural policies, DfID Rep Nick Dyer articulated the main downside risk to supporting the GOM through its fiscal and balance of payments difficulties: "The biggest concern in the near term is that the GOM could eventually sell off the maize stocks it is now accumulating

at highly subsized prices just prior to the elections. This would significantly worsen the fiscal problem. The GOM could also print money to cover increased electoral spending." USAID Mission Director Curt Reintsma also reminded the group that inadequate rainfall in the coming months could also dramatically transform the situation.

COMMENT: PRESERVING STABILITY NOW MAKES SENSE
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¶10. (SBU) Malawi's current situation has all the hallmarks of a classic case study in development economics: budget shortfall, election-year temptations, balance of payment pressures and international financial institutions (IFIs)contemplating conditionalities. There is reason to hope, however, that the ending will not be tragic. Senior GOM officials, including Finance Minister Gondwe, have given credible commitments to show restraint; and leading donors and IFIs seem determined to avoid imposing unrealistic conditions at a politically sensitive moment. Post believes that the USG should support efforts to ease macro pressures in Malawi, and then work with other donors to address policy concerns when the new Malawian government takes office. While there are clear political implications to supporting the GOM at the current juncture, our reasons for doing so would be non-partisan and based on Malawi's long-term interests.
SULLIVAN